United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

76-4174

Signed

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

WILLIAM B. STRONG and CONSTANCE L. STRONG, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

FRED W. POLLMAN and AGNES K. POLLMAN, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

PAUL W. HENNINGER and MABEL E. HENNINGER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

VICTOR L. ALGER and CORAL E. ALGER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

FREDERIC B. ADLER and HELEN P. ADLER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

COLBURN A. JONES and PATRICIA L. JONES, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

ON APPEALS FROM THE DECISIONS
OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

B

P6

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
TIMOTHY B. McBRIDE,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

TABLE OF CONTENTS

CITATIONS

Cases:

Cases (continued): Page

Statute:

Miscellaneous:

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 76-4174

WILLIAM B. STRONG and CONSTANCE L. STRONG, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

FRED W. POLIMAN and AGNES K. POLIMAN, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

PAUL W. HENNINGER and MABEL E. HENNINGER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

VICTOR L. ALGER and CORAL E. ALGER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

FREDERIC B. ADLER and HELEN P. ADLER, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

COLBURN A. JONES and PATRICIA L. JONES, Appellants

v.

COMMISSIONER OF INTERNAL REVENUE, Appellee

ON APPEALS FROM THE DECISIONS OF
THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court properly determined that a corporation created by taxpayers' partnership to obtain financing for the construction of an apartment complex and to hold title to

the property during the time of construction was a taxable entity, separate and apart from the partners and the partnership.

STATEMENT OF THE CASE

The Commissioner determined deficiencies[1/] for the taxpayers totalling $31,357.18 for the tax years 1968 through 1969. (R. 14.)[2/] The cases were consolidated for trial before the Tax Court and, on April 5, 1976, the Tax Court filed a consolidated opinion (66 T.C. No. 3) (R. 13-41) and entered decisions for the Commissioner (R. 1,3, 5, 7, 9, 11). The taxpayers filed timely notices of appeal on July 6, 1976. (R. 2, 4, 6, 8, 10, 12.) Jurisdiction is conferred on this Court by Section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C.).

The facts here involved are not in dispute and may be summarized as follows:

1/ The deficiencies were as follows (R. 14):

		1965	1966	1968	1969
1.	William B. and Constance L. Strong	0	0	$6,402.96	$4,725.61
2.	Fred W. and Agnes K. Pollman	0	0	1,946.00	520.00
3.	Paul W. and Mabel E. Henninger	0	0	929.95	361.17
4.	Victor L. and Coral E. Alger	0	0	491.57	178.33
5.	Frederic B. and Helen P. Adler	0	0	1,057.10	613.00
6.	Colburn A. and Patricia L. Jones	$1,333.00	$575.00	$2,691.00	$9,534.49

2/ "R." references are to the separately bound record appendix.

Prior to September, 1967, Colburn A. Jones, William B. Strong, Victor L. Alger, Frederic B. Adler, Fred W. Pollman and Paul W. Henninger agreed to form Heritage Village Apartments Company, a partnership, for the purpose of developing an apartment complex to be known as the Heritage Village Apartments. The partners understood at that time that financing in the amount necessary to develop the apartments was not available to individuals because of the limitations on interest charges in the New York usury statute. They understood that corporations were not subject to these limitations, and that financing might be available to a corporate borrower. Accordingly, Heritage Village, Inc., a corporation owned by the partnership (hereinafter referred to as the corporation), was formed in September, 1967, in anticipation of its use to obtain loan commitments. Jones was named as president and Robert V. Hunter as secretary of the corporation. The certificate of incorporation contained a broad and unqualified statement of purposes and authorized the issuance of 200 shares of capital stock without par value. (R. 15-16.)

In October, 1967, certificates of partnership were filed by the partners on behalf of Heritage Village Apartments Company (hereinafter the partnership).[3/] (R. 16.)

In August, 1967, before either the partnership or the corporation was formed, a commitment for a permanent mortage loan was obtained from the Bronx Savings Bank (hereinafter Bronx).

3/ The percentage interest in the partnership before and after the admission of a new partner, Robert Flannigan on August 21, 1969, were (R. 17):

This loan was to be secured by an 18 (later 19) building apartment project. The commitment letter was addressed to "Heritage-State Farm Corp. c/o Mr. Colburn A. Jones." (R. 16.)

By commitment letter of December 8, 1967, addressed to the corporation, the Chemical Bank of New York Trust Company (Chembank) agreed to loan the corporation $2,100,000 for construction of the first 18 apartment buildings. (R. 16.) The commitment letter contained several conditions. Chembank required that the corporation obtain builder's risk insurance, that it obtain an appraisal of the property and that Jones and his wife personally guarantee the loan. It further required that the corporation keep in full effect the long-term permanent mortgage commitment of the Bronx. (Joint Ex. 25-Y.) Chembank also required the corporation to deliver to Chembank an executed copy of a commitment of the Union Investing Corporation for a second mortgage of $315,000. (Joint Ex. 25-Y.)

On December 18, 1967, the partners executed two agreements. The first of these agreements was a formal partnership agreement.

3/ (continued):

Partner	Prior to 8/21/69	After 8/21/69
Jones	65.00	62.00
Strong	16.43	20.37
Adler	3.57	4.43
Henninger	3.57	4.43
Alger	1.43	1.77
Pollman	10.00	4.00
Flannigan	-	3.00

Flannigan took no operating loss deductions on his 1969 return. He is not involved in this litigation. (R. 17.)

Among other things, the agreement provided that Strong, Adler, Henninger and Alger, as partners in Strong and Company, were to transfer certain real property designated Parcel 1 "to the partnership or its nominee." (R. 17.) It also provided that (Joint Ex. 27-AA, pp. 2, 5-6, 8):

> It is agreed that title to the aforesaid Parcel may be held by a corporate nominee from time to time for the benefit of the partnership, it being the intention of the parties hereto that at all times the real and beneficial owner of the said Parcel shall be the partnership.
>
> *   *   *
>
> 6. Construction on Parcel 1--The parties hereto agree that Jones shall have and is hereby granted the authority on behalf of the partnership (through a nominee corporation, if determined by Jones and Strong) to negotiate for and enter into a Construction Loan Agreement, first or subordinate mortgage financing and related instruments * * * to finance the construction of the apartment units and related improvements on Parcel No. 1.
>
> *   *   *
>
> Jones agrees to guarantee such construction loan in the event that the lending institution shall request.
>
> Promptly upon execution of this Agreement the partnership shall enter into a Construction Agreement with Heritage-State Farm Corp., a New York corporation, the sole shareholder of which is Jones and/or his spouse. * * *
>
> Such construction * * * shall be in accordance with plans and specifications which shall be prepared on behalf of the partnership * * *.
>
> *   *   *

9. Authorized Signatures on Behalf of Partnership: The joint signatures of Jones and Strong shall be required on all deeds by the partnership, on any Construction Loan Agreement and on any bond and mortgage executed by or on behalf of the partnership.

The second agreement, an amendment to the first, provided for a transfer of Parcels 2 and 3 by the same four to the "partnership or its nominee." (R. 19.)[4/] The second agreement contained language similar to the above-quoted portion of the partnership agreement regarding conveyance to the partnership or its nominee and the holding of title by a corporate nominee for the benefit of the partnership. (Joint Ex. 31-AE.) A deed transferring Parcel 1 to the corporation was executed on December 27, 1967. Deeds transferring Parcels 2 and 3 to the partnership were recorded on January 25, 1968. (R. 20.)

On December 29, 1967, the corporation granted Chembank a mortgage on Parcel 1 and entered into a building loan agreement with Chembank. (R. 20.) The building loan agreement was executed by Jones as president and contained numerous covenants. The corporation agreed to execute a note for the amount loaned and to grant a mortgage to secure same. Paragraph 4(e) provided (Joint Ex. 33-AG, p. 5; R. 20):

4/ The agreement was further amended on August 21 and December 18, 1969, in respects not material herein.

4. Representations and Warranties. Borrower represents and warrants to Lender that:

*   *   *

(e) If Borrower purports to be a corporation, (i) it is a corporation duly organized, existing and in good standing under the laws of the state in which it is incorporated, * * * (iii) it has the corporate power, authority and legal right to carry on the business now being conducted by it and to engage in the transactions contemplated by this Agreement, the note and the mortgage and (iv) the execution and delivery of and the carrying out of the transaction contemplated by this Agreement, the execution and delivery of the Note and the Mortgage, and the performance and observance of the provisions of all the foregoing, have been duly authorized by all necessary corporate and stockholder actions of Borrower and will not conflict with or result in a breach of the terms or provisions of any existing law or any existing rule, regulation or order of any court or governmental body or of the Certificate of Incorporation or the By-laws of Borrower.

The agreement further stated that the corporation was the owner of Parcel 1 and had applied for the loan for the purpose of constructing 18 buildings containing 204 units. The corporation covenanted not to assign the agreement without Chembank's consent, and agreed to obtain a certificate of title and to insure the buildings against hazards as construction progressed. The corporation specifically covenanted in paragraph 8(c) (R. 21; Joint Ex. 33-AG, p. 9):

8. (c) Borrower shall furnish to Lender from time to time upon request (i) financial statements of Borrower, (ii) details relating in any manner to the financial condition of Borrower, and (iii) budgets

> and revisions of budgets of Borrower showing the estimated costs of construction of the Improvement and the amount of funds required at any given time to complete and pay for such construction.

The mortgage, which was recorded on January 8, 1968, contained numerous covenants and warranties and an explicit assignment of all rents and profits to the bank. The loan was personally guaranteed by Jones. (R. 21; Joint Ex. 34-AH.)

During 1968, 18 apartment buildings were completed on Parcel 1. (R. 21.) The corporation maintained accounts with Chembank and the Merchants National Bank and Trust Company (hereinafter Merchants) into which advances on the loan were deposited and from which the corporation made disbursements for construction either to the partnership, or directly to the contractor. Receipts for all advances were signed by Jones as president. (R. 26.)

As apartments were readied, they were leased to tenants in the name of the partnership as landlord. (R. 22.) The standard lease provided _inter alia_ that it was subject and subordinated to all mortgages on the property. (Joint Ex. 41-AO.) Upon completion of the 18 buildings, Chembank assigned the mortgage on Parcel 1 to Bronx. (R. 22.)

On December 27, 1968, the corporation entered into a loan extension agreement with Bronx. This extension was filed simultaneously with a declaration of easement by which the corporation, as owner of Parcel 1, and the partnership, as owner of Parcels 2 and 3, granted mutual easements to permit those who rented

apartments on Parcel 1 and their guests ingress and egress to a recreation area to be constructed on Parcel 3. (R. 22.) An amended declaration of this easement was executed on April 18, 1969. (Joint Ex. 39-AM.)

On the date of the extension agreement, the corporation also obtained an insurance policy protecting it as named insured (but for the benefit of Bronx as stated in the agreement) against damage to buildings and loss of rents. The policy covered completed portions of the buildings and was extended at times thereafter to include new buildings. The corporation remained named insured until December, 1969, when the insured designation was amended to include the partnership. (R. 22.)

On February 5, 1969, Chembank issued a commitment to the corporation for a loan of $135,000 to be used for constructing the 19th building on Parcel 1. (R. 22.) The corporation executed a mortgage, a note and a loan agreement with Chembank on March 24, 1969. They contained substantially the same provisions noted above regarding the first Chembank loan. Jones and his wife personally guaranteed the loan and completion of the building. (R. 23.) This mortgage was also later assigned by Chembank to Bronx. (R. 24.)

In May, 1969, a resolution was executed on behalf of the corporation authorizing it to obtain financing for construction of apartments on Parcel 2 and authorizing its officers, Jones and Hunter, to execute necessary documents on its behalf.

(R. 23-24.) The partnership had previously obtained from the Albany Savings Bank (hereinafter Albany) a commitment for a loan of $2,150,000. The commitment letters, however, stated the obligor was to be "a corporation to be formed by you." (R. 23.)

On May 9, 1969, the corporation gave Albany a note for $2,150,000 and a mortgage on Parcel 2 for security. The corporation again covenanted to purchase insurance for the benefit of the bank, warranted title, and assigned rents. It also promised to assign all subsequent leases on demand, to include subordination provisions in all leases, and to maintain proper records and accounts. (R. 23-24.) (Joint Ex. 50-AX.) Also on May 9, 1969, the partnership conveyed Parcel 2 to the corporation by deed which was recorded simultaneously with the mortgage. Jones again guaranteed repayment. (R. 24.)

On April 21, 1969, the corporation began the development of Parcel 3. On that date, it gave Merchants National Bank and Trust Company a mortgage on Parcel 3 to secure a loan of $75,000. (R. 24.) Title insurance for this loan was obtained from the Inter-County Title Guarantee and Mortgage Company which listed on its acknowledgement of receipt of an application for insurance, "TITLE IN: Heritage Village Apartments Company."; "TITLE TO BE IN: to be advised." (Joint Ex. 49-AW.) As had been previously agreed, the partnership transferred Parcel 3 to the corporation by deed recorded in June, 1969. (R. 24.)

Construction on Parcel 3 was completed in late 1969 and all buildings on Parcel 2 were completed by early 1970. As had been

the practice with apartments on Parcel 1, when a Parcel 2 apartment was completed, it was leased to a tenant in the name of the partnership. (R. 26.)

On December 23, 1969, Jones wrote a memorandum to Aaron Kaiser instructing him to prepare the papers necessary to convey all parcels from the corporation to the partnership after the corporation received the January loan advance from Albany. He was further instructed to transfer the property back and forth between the two entities so that title would be in the corporation only at the "moment an advance is made." This procedure was continued until May, 1970, when a warranty deed, transferring all parcels to the partnership, was recorded. (R. 25; Joint Ex. 54-BB.)

The corporation kept no books or records other than the above-mentioned bank accounts. Except for the advances on the construction loans and the disbursements thereof as aforesaid, all receipts and disbursements, income and expenses, and assets and liabilities pertaining to the construction and operation of the apartments--including rentals and all real estate taxes and water charges--were at all times received or made by, and carried on the books and records of, the partnership.

The corporation issued no capital stock. No corporate meetings were held nor minutes maintained. It filed federal income tax returns but reported no income, loss, assets or liabilities (reporting its principal business activity as "Nominee Corp.")

It did not apply for a federal employer identification number and had no employees.

From 1968 to 1970, the partnership employed various persons. Initially, these employees were carried on the payroll of the contractor as a matter of convenience; the contractor periodically billed, and was reimbursed by, the partnership for such compensation. Beginning in 1970, the partnership operated its own payroll account. It applied for and received an employer identification number.

During 1967 through 1969, the partnership dealt with various state and local authorities as owner of the property regarding installation of sewer and drainage pipes, connection for a water system, permits for roadwork, and settlement of a claim for violation of state conservation laws. Certain utility easements encumbering were released by agreement between the partnership and utilities in August, 1968. The agreement recited the partnership was the owner of the premises, but the record does not disclose which parcel or parcels had been so encumbered. (R. 28-29.)

Upon these facts, the Tax Court concluded that the corporation was a taxable entity separate and apart from the partnership. Accordingly, it rejected taxpayer/partners' claims that operating losses incurred during the years in question by the apartment complex were deductible by them as their distributive shares of partnership losses. The losses here involved, the Tax Court concluded,

were reportable by the corporation for purposes of the federal income tax.

Taxpayers appeal.[5/]

SUMMARY OF ARGUMENT

Heritage Village. Inc. was a New York corporation formed by taxpayers' partnership so that it could obtain sufficient financing for construction of an apartment complex. The individual partners contend that the corporation, although owner of the property, was a mere nominee that should not be recognized for tax purposes as a separate entity and consequently they should be entitled to take their distributive shares of the complex's net operating losses.

It is well settled, however, that if a corporation was organized for a business purpose or if it engaged in business activity, it must be recognized for tax purposes. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). There is no disputing--indeed, taxpayers concede--that the corporation here was formed for a business purpose. Taxpayers could not have obtained sufficient financing to begin their construction program had they not formed the corporation here and made it the owner of the apartment complex. As the Fifth Circuit (Collins v. United States,

5/ Pursuant to Section 7482(b)(2) of the Internal Revenue Code of 1954, the parties have stipulated that the appeal by Fred W. and Agnes K. Pollman may be heard by this Court. Mr. and Mrs. Pollman were residents of Arizona when they filed their petition with the Tax Court so that, in the absence of a stipulation under Section 7482, venue for their appeal would normally have been in the Court of Appeals for the Ninth Circuit.

514 F. 2d 1282 (1975), aff'g *per curiam*, 386 F. Supp. 17 (S.D. Ga., 1974)) and the Tax Court (*Bolger* v. *Commissioner*, 59 T.C. 760 (1973)) have held, this business purpose underlying the formation of a corporation is alone sufficient to mandate that the corporation be recognized for tax purposes.

And not only was the corporation here formed for a business purpose, it also actively engaged in so much business activity that it would constitute a taxable entity even had no business purpose informed its formation. The corporation here negotiated a series of loans, executed a series of mortgages and financing agreements, maintained bank accounts and contracted for insurance on and granted easements to the property to which it held title. As this Court's decision in *Paymer* v. *Commissioner*, 150 F. 2d 334 (1945), clearly shows, that history of business activity requires that the corporation be recognized for tax purposes.

Neither the doctrine of form over substance nor the cases taxpayers cite supports a contrary conclusion. Rather, the cases uniformly indicate that taxpayers cannot readily renounce the substantiality of the form they have chosen for the conduct of their business. Equally, taxpayers' citation of two recent Revenue Rulings dealing with the incidence of taxation with respect to construction undertaken pursuant to certain New York housing programs does not forward their case. These Rulings determined that in the complex factual situations there under consideration corporations could hold property as agents for partnerships. Taxpayers here have conceded (and the facts

demonstrate) that the corporation was not such an agent, rendering the Rulings totally inapposite. Finally, there is no other basis for reversing or remanding the decision below.

ARGUMENT

THE TAX COURT PROPERLY DETERMINED THAT HERITAGE VILLAGE, INC. WAS CREATED FOR BUSINESS PURPOSES AND ENGAGED IN BUSINESS ACTIVITIES, AND THAT IT WAS THEREFORE A TAXABLE ENTITY REQUIRED TO REPORT THE INCOME AND EXPENSES GENERATED BY THE APARTMENT PROJECT

More than 30 years ago, the Supreme Court established the test for determining whether a corporation or its shareholders should be taxed on income earned by the corporation. In holding that the corporation there was a taxable entity required to report its income for tax purposes, the Supreme Court stated in Moline Properties v. Commissioner, 319 U.S. 436, 438-439 (1943):

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * * In Burnet v. Commonwealth Improvement Co., 287 U.S. 415, this Court appraised the relation between a corporation and its sole stockholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages. (Emphasis added.)

Moline Properties thus created alternative tests for determining whether a corporation would be taxable on income earned by it--if it either was formed for a business purpose or engaged in

business, it was a taxable entity. We submit that there is virtually no room for disputing that the corporation here was created for a business purpose, or that it thereafter carried on business activities sufficient in themselves to require taxability had there been no original business purpose. See, e.g., Paymer v. Commissioner, 150 F. 2d 334 (C.A. 2, 1945).

Heritage Village, Inc. was a New York corporation formed by a partnership, the Heritage Village Apartments Company, in connection with the construction and operation of an apartment complex. Title to the realty involved was transferred to the corporation because, under New York law, corporate ownership was almost a precondition to the obtaining of sufficient construction.[6/] Indeed, taxpayers concede that corporate ownership of the realty here was absolutely essential to their development plans. And, as the Tax Court found (R. 37), the corporation when formed actively engaged in business. The corporation filed a certificate of incorporation with a broad and unqualified statement of purpose, and thereafter performed numerous business activities during 1968 through 1969. It took title to three parcels of real estate; it granted mortgages or extensions thereof on six occasions with four lending institutions, and executed notes and agreements in relation thereto (R. 24-25); it granted and amended a declaration of easement (R. 22); it maintained two bank

6/ Under New York law (General Obligation Law, McKinneys Consol. Law of N.Y. Ann., § 5-521 (McKinney Supp. 1975-76)) corporations cannot plead the defense of usury. See Tax Court opinion, footnote 7, and accompanying text. (R. 30.)

accounts into which it deposited advances on loans taken by signed receipt and from which it made payments to two entities (R. 26); it passed one resolution authorizing its officers to obtain a loan (R. 23-24); and it purchased an insurance policy in its own name (R. 22).

On this record, then, the Tax Court had virtually no choice but to hold that the corporation here was an entity for tax purposes and that it was required to report the income earned by and was entitled to deduct the expenses incurred by the apartment development. The corporation here was formed for a business purpose and thereafter engaged in business activity. Its status as a taxable entity was mandated by the decision in Moline Properties, supra.

The correctness of the decision below is, moreover, borne out by a series of decisions applying the Moline Properties test to situations similar to the one at hand. Thus, in Collins v. United States, 514 F. 2d 1282, 1283 (C.A. 5, 1975), aff'g per curiam, 386 F. Supp. 17 (S.D. Ga., 1974), a Georgia corporation was--

> formed for the single purpose of obtaining a temporary loan during construction of an apartment project--because the only loan money available would have been at a usurious rate under state law if made to the individuals carrying out the project * * *.

The taxpayers transferred title to the realty to the corporation, Bencap, Inc., which then obtained a construction loan. The taxpayers agreed that the corporation was to act as their trustee

and the corporation entered into an agreement with the taxpayers "acknowledging the limited purpose of its corporate existence and the obligation to reconvey legal title to the taxpayers" after the need for corporate ownership came to an end. The corporation maintained bank accounts to pay construction expenses and entered into apartment leases that it assigned to the bank as further security for the loan. The District Court held that the corporation, rather than its shareholders, should report the income and expenses of the apartments. It reasoned (386 F. Supp. pp. 20-21):

> Obviously, plaintiffs were keenly aware of the prospective advantages to them as individuals in the matter of depreciation and interest for tax purposes and anxious to preserve them. Faced with the fact that Georgia law did not permit the lending institution to charge the rate of interest it was accustomed to collect in construction loans, the tenants-in-common were forced to resort to the corporate form in order legally to pay the higher interest rate required. To preserve their tax deductions as individuals, the corporate phase of the venture was restricted to the barest minimum--the temporary borrowing and mortgaging in the name of a corporation. Bencap, Inc. was allowed to exist as little more than a name.
>
> The fact remains, however, that the corporation did exist and did perform the function intended of it until the permanent loan was consummated. It was more than a business convenience, it was a business necessity to plaintiffs' enterprise. As such, it came into being. As such, it served the purpose of its creation.
>
> I do not perceive how plaintiffs can maintain that Bencap, Inc. was only a fictive creature (a dummy or straw corporation) to be ignored when it came to the tax advantages of the individuals arising out of a business venture that would not have fructified without the use of the corporate device in connection with the temporary financing of the project. A taxpayer cannot shop on both sides of the street at the same time. He

> cannot avail himself of the business advantages of the corporate form while disregarding it in the case of its tax disadvantages. "The choice of the advantages of incorporation to do business requires 'the acceptance of the tax disadvantages'." Harrison Property Management Co., Inc. v. United States, supra, 475 F. 2d [623], 626 [Ct. C., 1973].

On appeal, the Fifth Circuit affirmed the District Court's judgment per curiam "for the reasons well stated in * * * [the District Court's] opinion." 514 F. 2d, p. 1283.

Similarly, in Bolger v. Commissioner, 59 T.C. 760 (1973) acq. 1976-20 Int. Rev. Bull. 6, the Tax Court held that corporations used to avoid limitations of state usury laws were taxable entities. In Bolger, the taxpayer formed a number of corporations in connection with his acquisition of various rental properties. Each corporation took title to a single parcel of realty, executed a single lease, issued corporate notes to a lender, and secured a loan with a mortgage and assignment of the lease. Thereafter, and usually within a few days of its creation, the corporation would convey its interest in the real property to the taxpayer/shareholder and he would agree to assume the corporation's obligations under the mortgage. The Tax Court held they required recognition, stating (p. 766):

> There is no question that * * * [the corporations] were organized and utilized in the initial stages for business purposes, namely, to enable the contemplated transactions to produce maximum financing by avoiding State law restrictions on loans to individuals rather than corporate borrowers * * *. In furtherance of these purposes, the corporations purchased the properties, entered into the leases, issued their corporate obligations, and executed mortgages

> and assignments of the leases as security for the payment of those obligations. At that point of time the corporations were undoubtedly separate viable entities whose separate existence could not be ignored for tax purposes.

See also, Preferred Properties Inc. v. Commissioner, P-H Memo T.C., par. 76-018 (1976).

We submit that the Collins and Bolger decisions are direct authority for the decision below. The purpose served by this corporation was exactly the same as that served by the corporations in Collins and Bolger. And the corporation here was more active than the corporations in those two cases. The corporation here, as opposed to the corporation in Collins or the corporations in Bolger, entered into a whole series of financing arrangements. It granted an easement, secured insurance in its own name and generally retained its separate and independent operating existence for a longer period of time than the corporations there.

Taxpayers, of course, attempt to distinguish Collins on the basis that the corporation there entered into leases covering the newly-constructed property, while the apartments here were nominally rented out by the taxpayers' partnership. (Br. 28.) However, as the Tax Court noted (R. 26) this fact alone does not provide a "sufficient basis for distinguishing * * * [the] thrust" of Collins and other cases. (R. 38.) It in no way serves to avoid the clear teaching of Collins that a corporation formed for the business purpose of securing adequate financing must be recognized for tax purposes. Nor does it adequately distinguish Collins from the present case as to the business activity phase of the

tax entity test. Although the corporation here did not enter into any leases, it did agree to assign rents in at least three of its mortgage agreements. (Joint Exs. 34-AH, 44-AR, 50-AX.)[7/] And the standard lease specifically provided it was subordinate to mortgages on the property. (Joint Ex. 41-AO.) Thus, in effect, the corporation was an indirect beneficiary of at least some of the leases here.

Indeed, this Court's decision in Paymer v. Commissioner, 150 F. 2d 334 (1945), indicates that the business activities undertaken by the corporation here were alone sufficient to require that it be recognized for tax purposes. In Paymer, the taxpayers transferred certain real property to two corporations in order to shield them from potential creditor claims. Each of the corporations acknowledged that they were holding title for the benefit of the taxpayers and that they had been formed "for the convenience" (p. 336) of the taxpayers. Neither of the two corporations held any meetings apart from the organizational meeting, neither maintained any officers, had a bank account or collected any income. The taxpayers managed the property nominally owned by the corporations as though the corporations did not exist. One of these corporations, Raymep, did, however, engage in

---

7/ The mortgage agreement with Merchants for Parcel 3 construction was not offered in evidence.

In the mortgages with Bronx, the corporation agreed that an assignment of rents without consent would be a default and further, that on default all existing leases would be assigned. (Joint Exs. 38-AL, 33-BA.)

a very limited amount of business activity. It obtained a $50,000 loan and, as security, assigned to the lender "all the lessor's rights, profits and interest in two leases on the property and covenanted that they were in full force and effect and that it [the corporation] was the lessor." 150 F. 2d, p. 336. This Court held that this limited amount of activity mandated recognizing Raymep as a taxable entity. It stated (150 F. 2d, pp. 336-337):

> We think that Raymep was active enough to justify holding that it did engage in business in 1938. The absence of books, records and offices and the failure to hold corporate meetings are not decisive on that question. Though Raymep was organized solely to deter creditors of one of the partners, it apparently was impossible or impracticable to use it solely for that purpose when it became necessary or desirable to secure the above mentioned loan in a substantial amount. There was, to be sure, less business activity than was shown in Sheldon Building Corporation v. Commissioner of Internal Revenue, 7 Cir., 118 F. 2d 835, but we think enough did appear to make the principles applied in that case applicable to Raymep and that the decision of the Tax Court should be affirmed as to the taxability of that corporation.

If Raymep's activities with respect to one loan were of such a magnitude to require its recognition for tax purposes, the activities of the corporation here in obtaining the series of loans needed for the construction of the apartment complex, in granting easements and in obtaining insurance must surely mandate tax recognition.[8/]

8/ Taxpayers' attempt to distinguish Paymer on the ground that the corporation there entered into a lease--and thus engaged, they contend, in income producing activity--while the corporation here did not directly enter into leases. This distinction has no merit. To begin with, the activities of the corporation were as

(continued)

Taxpayers, however, attempt to avoid the clear teaching of Moline Properties, Collins, Bolger and Paymer by arguing that nonrecognition of the corporation is mandated by the doctrine of form over substance and by a number of cases in which corporations were disregarded for tax purposes. What taxpayers fail to recognize is that, they having chosen the form in which they would conduct their business, they have little standing now to contend that they are not taxable in accord with their chosen form. Thus, in Higgins v. Smith, 308 U.S. 473, 477 (1940), the Supreme Court noted:

> A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.
>
> On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business * * * is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute.

See also Moline Properties, supra. And, in Commissioner v. State-Adams Corp., 283 F. 2d 395, 399 (C.A. 2, 1960), cert. denied, 365 U.S. 844 (1961), this Court pointed out that the Commissioner has "greater freedom and responsibility" to disregard

---

8/ (continued):

profit oriented as were the activities of the corporation in Paymer. Moreover, as we have pointed out (see fn. 7, p. 21, supra), the corporation here was at least the indirect beneficiary of the leases covering the apartments in the development and could properly be considered a party to those leases.

the corporate form than a taxpayer "who normally cannot be heard to complain that a corporation which he has created, and which has served his purpose well, is a sham."

Accordingly, virtually all of the cases upon which taxpayers rely involve situations in which corporations have been denied tax recognition at the instance of the Commissioner. Thus, in O'Neil v. Commissioner, 170 F. 2d 596 (C.A. 2, 1948), cert. denied, 336 U.S. 937 (1949), the taxpayer had transferred certain realty, including his residence, to two corporations simply to enable him to deal with the property without having to obtain his wife's signature. This Court found the stated purpose was a "slight approach to a business purpose and did not amount to a business activity" (Id. p. 598), and thereby sustained the Commissioner's determination that certain advancements made by the taxpayer to the corporation could not be deducted as bad debts. Similarly, in Jackson v. Commissioner, 233 F. 2d 289 (C.A. 2, 1956), this Court again found that corporations which served only as devices to insulate stock owned by Mrs. Jackson from her husband's creditors were not created for a business purpose, and could be disregarded by the Commissioner for purposes of taxation of transactions between the corporation and taxpayer.

Taxpayers also cite United States v. Brager Building and Land Corp., 124 F. 2d 349 (C.A. 4, 1941), in which the court agreed with the Commissioner that the corporation could be disregarded. It had been created simply as an agency to hold title

to real estate to help avoid future complications on the death of its creator.

In addition to these cases which concern corporations created for personal reasons not amounting to business purposes, the Commissioner has successfully sought to disregard the corporate form where it has been used for tax avoidance. In Shaw Construction Co. v. Commissioner, 323 F. 2d 316 (C.A. 9, 1963), the court found the taxpayer, a home-building corporation, had created numerous subsidiaries only for income splitting and could be disregarded. See also, James Realty Co. v. United States, 280 F. 2d 394 (C.A. 8, 1960); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582 (1959).

When, on the other hand, taxpayers have sought to avoid the tax implications of their choice of the corporate form of doing business, they have been largely unsuccessful. See, e.g., Bolger v. Commissioner, supra; Collins v. United States, supra. Thus, in Commissioner v. State-Adams Corp., supra, this Court reversed a Tax Court decision favorable to such an argument. A corporation had been formed to hold title to certain realty and thereby lessen problems of succession upon the death of its owner. The court disagreed that the corporation was a mere nominee to hold title and found that it had engaged in sufficient business connected with the ownership of the land to require its recognition for tax purposes. And the court, distinguishing O'Neil v. Commissioner, 170 F. 2d 596 (C.A. 2, 1948), cert. denied, 336 U.S. 937 (1949) and Jackson, supra, stated that a taxpayer cannot normally be

heard to complain that his corporation is a sham. See also, Gregg Co. of Delaware v. Commissioner, 239 F. 2d 498 (C.A. 2, 1956), cert. denied, 353 U.S. 946 (1957); Esmond Mills v. Commissioner, 132 F. 2d 753 (C.A. 1, 1943), cert. denied, 319 U.S. 770 (1943).

Indeed, the only case cited by taxpayers in which a corporation was disregarded at the urging of its creator is Paymer v. Commissioner, supra, where this Court held that one corporation that had neither been formed for a business purpose nor had conducted any business whatsoever could be disregarded at the taxpayers' instance. As we have pointed out, the taxpayer was unsuccessful as to a second corporation that had been used by its creators to obtain a single loan and was "active enough" to require recognition. 150 F. 2d, p. 336. Paymer, therefore, contains no authority for disregarding the corporation here which was intended to serve a business purpose and engaged in business activities which, as the Tax Court pointed out, "were more extensive than those which required recognition" of the second corporation. (R. 38.)[9/]

9/ Appellants cite several additional cases in which taxpayers have unsuccessfully sought to have their own corporations disregarded. E.g., Love v. United States, 96 F. Supp. 919 (Ct. Cl., 1951); Given v. Commissioner, 238 F. 2d 579 (C.A. 8, 1956); Hagist Ranch, Inc. v. Commissioner, 295 F. 2d 351 (C.A. 7, 1961); Tomlinson v. Miles, 316 F. 2d 710 (C.A. 5, 1963), cert. denied, 375 U.S. 828 (1963); and Harrison Property Management Co. v. United States, 475 F. 2d 623 (Ct. Cl., 1973), cert. denied, 414 U.S. 1130 (1974), rehearing denied, 415 U.S. 952 (1974). Taxpayers argue these cases establish that recognition will attach only to corporations with more substantial purposes or activities. Even

(continued)

The Moline Properties test applied by the Second Circuit in Paymer, the Fifth Circuit in Collins, the Tax Court in Bolger and below, is the standard for separating form from substance in this type of case. The threshold of requisite purpose or activity as shown by these authorities is low. Cf. Paymer v. Commissioner, supra. The requisite activity may be "minimal." Britt v. United States, 431 F. 2d 227 (C.A. 5, 1970). The Tax Court correctly concluded that both the purpose and activity of Heritage Village, Inc. constituted more than sufficient substance to require tax recognition of the corporate form.

Taxpayers also assert that the Tax Court in reaching its conclusion relied on several factors they argue are not inconsistent with their contention that "the [partnership and corporation] were the same entity" and thus added nothing to the analysis. (Br. 35.) These factors include applications for and purchase of insurance, creation of easements, the collateral benefit of insulation of personal liability of the partners (except Jones), and the fact that Jones' signature was sufficient to execute corporate agreements while both Jones' and Strong's signatures were required to bind the partnership. (Br. 39-40.)

It is quite clear, from a reading of the opinion, however, that the court had already concluded that the corporation's broad

9/ (continued):

conceding arguendo that the business activities in these cases were more substantial, none is authority for disregarding Heritage Village, Inc.; the quantum of requisite business activity "may be minimal." (Emphasis added.) Britt v. United States, 431 F. 2d 277, 237 (C.A. 5, 1970).

powers, several mortgage transactions, and receipts and application of loan proceeds were sufficient in themselves to warrant recognition; they were "more extensive" than activities requiring recognition in other cases. (R. 26.) Only then does the court discuss the factors to which the taxpayers now point. But it cannot be disputed seriously that these factors are irrelevant to the analysis. For example, the partnership could not have granted the easement and extension thereof; it was not the owner of Parcel 1. (R. 22.)[10/]

Taxpayers also urge (Br. 38) that the conclusion reached by the Tax Court below is inconsistent with the position expressed by the Commissioner in two recent Revenue Rulings. Both of these Rulings (Rev. Rul. 75-31, 1975-1 Cum. Bull. 10, and Rev. Rul. 76-26, 1976-4 Int. Rev. Bull. 5) considered whether a limited partnership or a corporation was to be treated as the owner of a housing project for federal income tax purposes. While the two rulings concluded that the limited partnerships there might be considered owners, the facts underlying those conclusions are readily distinguishable from the facts here.

10/ Taxpayers argue the Tax Court's decisions have raised the spector of additional "potential liabilities" (Br. 37) in the form of taxes on the 1970 transfer of the property to the partnership (which they equate to a liquidation). While it will be soon enough to deal with these potentialities when the year 1970 is before this Court, we might note that, although the Government has recognized the corporation for purposes of reporting income and expenses, it does not necessarily follow that it must give recognition to the same corporation for purposes of dissolution. See, e.g., O'Neil v. Commissioner, supra, pp. 597-598.

Each ruling concerned a Limited Profit Housing Corporation (LPHC) formed as a prerequisite to obtaining loans from certain New York State Loan programs for construction of low income and other housing. Such loans are administered by the state Housing Finance Agency (HFA), in the case of Rev. Rul. 75-31 and the state Urban Development Corporation (UDC) in Rev. Rul. 76-26. The LPHC's are limited in their permissible uses by statute, and their formation and use are absolute prerequisites to access to the state loan programs.

In addition, they are tightly regulated by the state. As outlined in Rev. Rul. 75-31, HFA loans are approved by the state Division of Housing and Community Renewal (the Division). This Division must approve the certificate of incorporation of a LPHC before it is filed with the state. The certificate must state the LPHC is formed for a public purpose and that it remains subject to the supervision and control of the commissioner of the Division. In addition, it must acknowledge that in the event it violates any provision of its certificate, or any applicable state law or regulation of the Division, or any provision in any loan contract or mortgage, the Commissioner is empowered to take over control of corporation and do whatever is necessary--including firing all the directors--to insure against recurrences of the violation.

In addition to similar restrictions, LPHC desiring a UDC loan, the subject of Rev. Rul. 76-26, must also be a "subsidiary" of the UDC. This can be effected, as the facts in the ruling

indicate, by providing in the certificate a stock pledge agreement and irrevocable proxy between the UDC and the private entities involved.

In each case the LPHC filed annually a Form 56, Notice of Fiduciary Relationship with the Internal Revenue Service.

In each case the Internal Revenue Service, applying the test contained in National Carbide Co. v. Commissioner, 336 U.S. 422 (1949), ruled that the corporation could be considered the "agent" of its owner and that the partnership would be treated as owning the property nominally owned by the corporation. Under the circumstances involved in the two Revenue Rulings, the agency relationship was not solely dependent on the fact of stockholder ownership. Rather, the agency relationships described in the rulings were the result of the requirements of the state's authorities which maintained control over LPHC's, and thus were relations which existed of statutory necessity. They were not explainable simply by the corporation-stockholder relationship. Thus, under the circumstances there, "the so-called 'agent' would have made the agreement if the so-called 'principals' were not its owners, and conversely * * * the 'principals' would have undertaken the arrangement if the 'agent' were not their corporate creature." Harrison Property Management Co. v. United States, supra, p. 627.

In the instant case, however, taxpayers have correctly conceded that Heritage Village, Inc. could not be considered the agent of the partnership. (Br. 35.) Yet they attempt to equate

their "nominee" or sham argument to the agency concept applied by the rulings. Taxpayers cannot have it both ways. Having disavowed the agency contention, they are barred now from contending that these rulings constitute authority for disregarding their corporation.

In any event, this case is distinguishable on its facts. As is implicit in taxpayers' concession, it is clear that the taxpayers would not have conveyed title to the property here to the corporation had they not owned all the stock in that corporation. Rather, the corporation's relationship with the partnership was entirely "dependent upon the fact it was owned by" the partnership. As the Supreme Court indicated in National Carbide Corp. v. Commissioner, supra, p. 437, such a relationship does not constitute an agency relationship for purposes of the federal income tax.

Nor is there any substance to taxpayers' argument that the business purpose underlying the creation of the corporation ceased either when the loan documents were executed by it, or at least when the permanent mortgage on Parcel 1 was consummated and that all income and deductions stemming from the property thereafter ought to be reportable by the partnership. (R. 44.) To begin with, it should be pointed out that this argument was not raised in either the pleadings or the brief filed with the Tax Court. Therefore, it should not be heard on appeal.

Moreover, there is no factual basis for their assertion that the corporation ceased to serve a business purpose at some time

during the years in issue. They argue that the business purpose of Heritage Village, Inc. ceased when it executed the construction loan documents. But the loan transaction, the central purpose for which Heritage Village, Inc. was formed, did not cease on that date; rather, it continued throughout subsequent months when advances were made. And it entailed continuing obligations of the corporation. For example, the initial loan agreement and mortgage with Chembank contained a requirement that the corporation furnish the bank financial statements from time to time, an agreement by the corporation not to assign the contract (Joint Ex. 33-AG), and the corporation's covenant that it would maintain insurance on the property (Joint Ex. 34-AH). Thus, the business purpose of Heritage Village, Inc. continued at least during the existence of construction loans.

Taxpayers argue alternatively that the business purpose of the corporation ceased as to Parcel 1 on January 15, 1969. On that date, the corporation and Bronx entered into an extension agreement of the Chembank loan for construction of the first 18 buildings on Parcel 1. (R. 22.) But contrary to taxpayers' assertion, the business purpose served by the corporation with respect to Parcel 1 did not then terminate because within three weeks, on February 5, 1969, Chembank issued its commitment to loan the corporation $135,000 for the construction of the 19th building on Parcel 1. (R. 22-23.) This loan was given in March, 1969. It was not until July 17, 1969, that Bronx entered a consolidation agreement of the two Chembank loans. (R. 24.) Thus, if taxpayers

are to prevail in this argument, the earliest date on which the corporation's business purpose as to Parcel 1 could be considered to have ceased would be July 17, 1969, the date the permanent loan was executed.

But even on July 17, 1969, and throughout 1969, until all construction on the complex was completed and title was transferred to the partnership in 1970 (R. 25-26), the corporation continued to serve the purpose of its creation, enabling the construction financing of the Heritage Village Apartments Complex. Further, it served the additional purpose of limiting the personal liability of most of the partners. (R. 39.)

Moreover, while the Moline Properties test has been applied to distinguish between those corporations that will be recognized for tax purposes and those that will not (e.g., Paymer v. Commissioner, supra), it has never been applied to distinguish assets owned by a single corporation. The test is concerned with whether the corporation itself is a taxable entity. If it is, it must report all of its income and deductions. Its purpose with respect to a single asset may be considered, but that is merely part of the overall analysis to determine whether it in fact served a business purpose. Cf. Paymer v. Commissioner, supra.

In this case, the corporation owned Parcel 1 during all of 1969, and Parcels 2 and 3 from May and June respectively until the end of 1969. (R. 20, 24.) During all of 1969, construction continued on some part of land owned by the corporation. (R. 21-23, 26.) During all of 1968 and 1969, the corporation served its

purposes and actively conducted business and was a separate taxable entity. Its separate existence must be recognized because of its "continued participation in a business arrangement during * * * [these] years." Raymep Realty Corp. v. Commissioner, 7 T.C.M. 262, 267 (1948).[11/]

CONCLUSION

For the reasons appearing above, the decisions of the Tax Court should be affirmed.

Respectfully submitted,
Scott P. Crampton
SCOTT P. CRAMPTON
Assistant Attorney General,

GILBERT E. ANDREWS,
MICHAEL L. PAUP,
TIMOTHY B. McBRIDE,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

NOVEMBER, 1976.

11/ Taxpayers' reliance on Bolger v. Commissioner, supra, in further support of their argument is misplaced. In Bolger the Tax Court found certain corporations formed by the taxpayer to avoid state usury laws were taxable entities. It also found, however, that after the mortgaged property had been transferred back to the taxpayer, subject to the mortgage and leases, he was entitled to report the depreciation incurred upon the property. It is clear that had the property not been transferred to the taxpayer, the court would have reached a different conclusion. The property here was owned by the corporation throughout the tax periods involved.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 3d day of November, 1976, in an envelope, with postage prepaid, properly addressed to him as follows:

Robert V. Hunter, Esquire
Hunter and Hartnett
P.O. Box 30
5795 Widewaters Parkway
Dewitt, New York 13214

Gilbert E. Andrews
GILBERT E. ANDREWS, Ant
Attorney.